



Testimony

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CHINA TRADE

WTO Membership and Most-Favored-Nation Status

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Mr. Chairman and Members of the Subcommittee:

I am pleased to have this opportunity to provide this statement for the record for your hearing on June 17, 1998. I would like to offer some observations on the People's Republic of China's negotiations to join (accede to) the World Trade Organization (WTO). Today's hearing is about the President's recent decision to extend China's waiver and continue to grant most-favored-nation (MFN)¹ status to China. You requested that we explain the relationship between China's MFN status and WTO membership. My statement will explain (1) the WTO accession process and (2) the legal framework affecting China's MFN status, its implications for WTO membership, and the role Congress plays in the process.

My observations are based on our past and ongoing work;² our review of WTO and executive branch documents; U.S. law; and related literature; the economic literature; and our discussions with U.S. government, WTO, and foreign government officials. Before getting into the specifics of these topics, let me provide a brief summary of my statement.

Summary

China has the largest economy worldwide that is not covered by the WTO. The WTO seeks to promote open and fair international trade through increased transparency (public openness), rules, and commitments to reduce barriers on foreign goods and services, and provide a binding system for resolving disputes. China would like to join the WTO and is currently in the negotiation phase, which is the second of the four-stage process for becoming a member. Joining the WTO will require China to make substantial changes to its economy. Although Congress does not vote on China's WTO membership, the United States Trade Representative (USTR) is required to consult with Congress before a WTO vote is taken. The administration plans to ask Congress to enact legislation to resolve a potential conflict between the conditional MFN afforded China under U.S. legislation and the unconditional MFN provided by the WTO agreements. If China becomes a member and Congress has not enacted this legislation, the administration intends to invoke a WTO provision that would permit the United States not to apply the WTO agreements to China. An important consequence of taking this exception is that China and the United States would not be obligated to provide each other all the WTO trade

¹The MFN treatment generally refers to the practice of extending to a country the best trade privileges granted to any other nation. For example, imports from countries receiving MFN treatment are provided the lowest tariff rates and other charges imposed on imported products.

²See related GAO products at the end of this testimony.

commitments that they would give to other WTO member states. In such a situation, U.S. business may not be able to benefit fully from the commitments China will make to open its markets to other WTO members.

Background

Since the late 1970s, China has introduced a variety of market reforms to liberalize its centrally planned economy. Today, China is much more developed, open, and market oriented, such that now almost all sectors of its economy have elements of both free markets and state planning. However, China still lacks considerable transparency in its trade regime and intervenes in its economy in ways that can distort trade. For example, China restricts its imports by applying high tariffs to specific sectors, using import quotas, requiring import licenses, imposing other import barriers, and promoting and supporting its exports. In combination with macroeconomic forces, these trade practices have fostered a Chinese balance of trade surplus with the world and a rapid buildup in foreign reserves.

In addition to these factors, the U.S. trade deficit with China has recently grown because U.S. demand for goods from China has grown more rapidly than Chinese demand for U.S. goods. Over the past 4 years this bilateral U.S. trade deficit has risen from \$30 billion to \$50 billion.³ Top U.S. exports to China tend to consist of high-technology goods, such as aircraft, while the top U.S. imports from China include many low-technology products such as toys and apparel. U.S. imports from China also include products such as electrical machinery. The United States has negotiated with China to open its markets through numerous bilateral trade agreements, including a 1979 agreement that approved reciprocal MFN status between the two countries⁴ (for more information on U.S.-China bilateral trade agreements, see app. I).

Since 1986, China has been negotiating to join the WTO and its predecessor, the General Agreement on Tariffs and Trade (GATT). China will have to make significant changes to its economy to be able to meet WTO commitments (for a brief discussion of China's economy, see app. II).

³There is sometimes a discrepancy between the trade statistics of the United States and China, mainly because of the differences in how they calculate bilateral trade through Hong Kong.

⁴The Agreement on Trade Relations was signed on July 7, 1979, under section 405 of the Trade Act of 1974, as amended. Section 405 authorizes the United States to enter into bilateral commercial agreements that provide MFN status to other countries if the President determines that such agreements promote the purposes of the act and are in the national interest. The agreement is subject to renewal at 3-year periods, but all or part of the agreement may be suspended if a party lacks the domestic legal authority to implement it. The agreement was recently renewed on February 1, 1998.

Existing WTO members and countries that agree to join the WTO⁵ must abide by a set of rules and obligations that promote trade and increase transparency and fairness in the world trading system. Nondiscrimination toward other WTO members is a fundamental principle in the WTO agreements⁶ and is embodied in the granting of MFN status and providing national treatment. Generally WTO members are obligated under the MFN principle to grant each other trade privileges as favorable as they give to any other foreign country. National treatment requires that they treat other member's products no less favorably than they treat their own, once foreign goods have crossed their borders.

China, like other WTO members, will also have to commit to reduce tariffs for industrial and agricultural products and to follow rules designed to limit the use of trade-distorting nontariff barriers (such as subsidies and import licensing requirements). Additional WTO rules cover financial and other services, trade-related investment measures, market access, and trade-related intellectual property rights. WTO members have access to dispute settlement procedures designed to help them more quickly address other members' trade practices that appear to violate WTO rules.⁷

China has sought to join the WTO as a developing country, which would allow it to benefit from longer transition periods given these countries to implement WTO obligations. However, the United States and other countries have maintained that China should be treated as a developed country because of its size and status as a major world exporter. While there is debate about the true size and growth rate of China's economy, there is no doubt that it is very large and has grown rapidly. The Organization for Economic Cooperation and Development (OECD) estimates that China's gross domestic product (GDP) was the second largest in the world in 1997. Despite its size, however, China's economy still is considered "developing" by World Bank estimates. According to U.S. and foreign government officials, negotiations on transition periods and other special treatment for China will be considered on a case-by-case

⁵There are currently 132 WTO members, and an additional 31 have applied for membership. Another 32 countries worldwide are not members of the WTO nor have they applied to join, according to our analysis.

⁶As used in this testimony, the WTO agreements refer to the agreement establishing the WTO and the binding Multilateral Trade Agreements set forth in annexes 1, 2, and 3 of that agreement, as well as subsequent revisions and additions to those agreements. This includes the Dispute Settlement Understanding.

⁷Various WTO agreements establish a national security exception to otherwise agreed to commitments. Under this exception, WTO members can take certain generally described actions they consider necessary for protection of their essential security interests.

basis since China does not fit neatly into either of these categories of development.

Overall, a major objective of the administration has been to negotiate a WTO accession agreement that is “commercially meaningful to U.S. business.”⁸

WTO’s Accession Process

China is currently negotiating with WTO members, including the United States, to join, that is, to “accede” to, the WTO. After joining, China will be bound by the commitments it makes both in the accession negotiations and in the underlying WTO agreements. A successful accession requires the applicant to make the necessary concessions to meet the commercial and trade requirements of the WTO agreements. Thus, the outcome of this process is, to some degree, already determined by the existing agreements, in contrast to traditional trade negotiations; the primary issue for debate is agreeing to what measures a country like China needs to take to assure WTO members that it can meet the requirements. Also, the applicant must negotiate the levels at which it will bind its tariffs⁹ with WTO members. Any special provisions granted to the applicant are counterbalanced by greater obligations that the applicant must fulfill. For instance, although members might allow the applicant time to phase in tariff reductions, the applicant might be required to meet additional reporting and transparency commitments during the phase-in process.

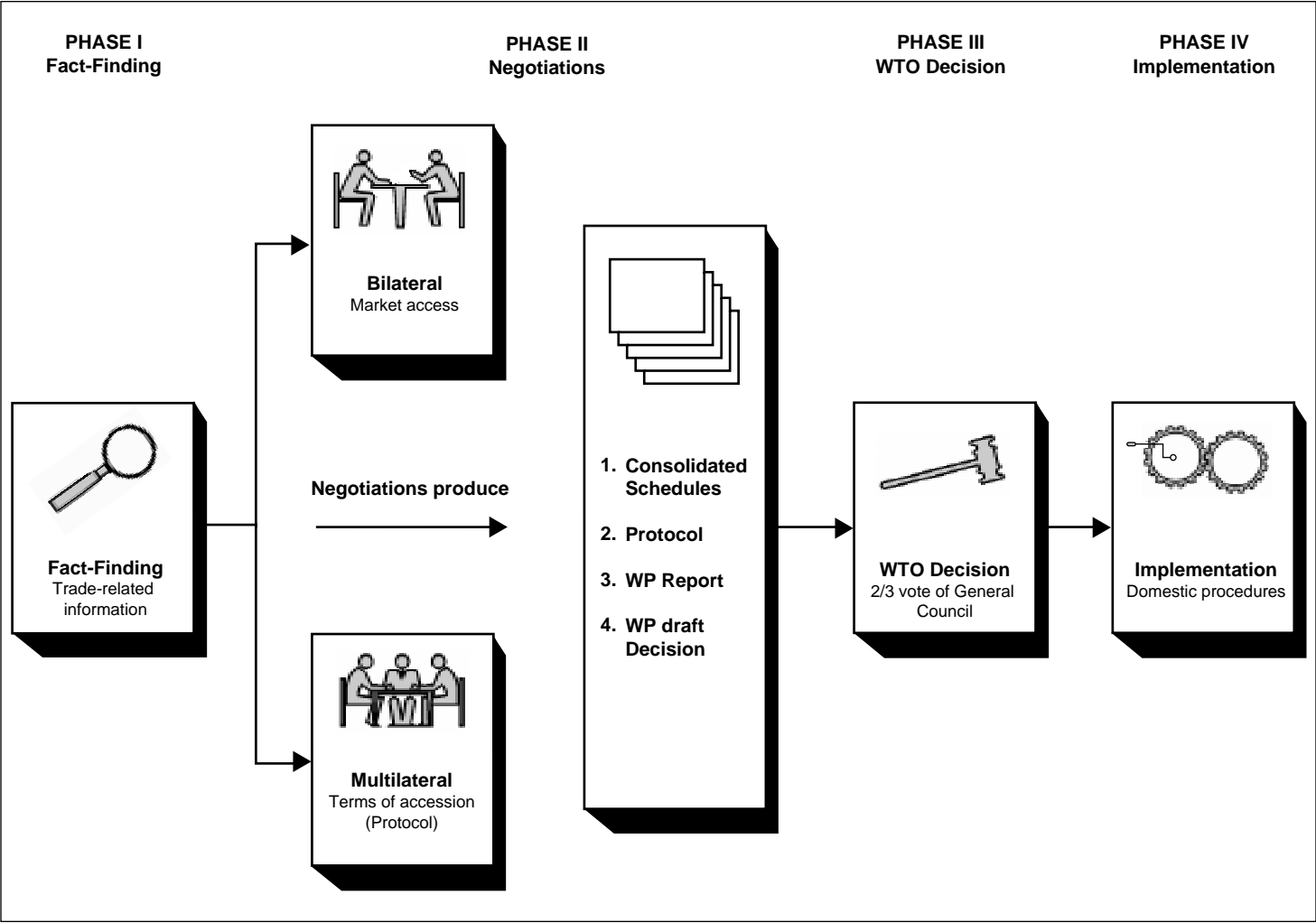
The accession process begins when the applicant submits a letter of application to the WTO Director-General. China began this process in 1986 when it applied to the GATT, and renewed its application in 1995 upon the creation of the WTO. This process, diagrammed in figure 1, is comprised of four phases:¹⁰ (1) fact-finding, (2) negotiation, (3) WTO decision, and (4) implementation. China is currently in the negotiation phase of the accession process.

⁸USTR 1998 Trade Policy Agenda and 1997 Annual Report, p. 11.

⁹In international trade, the concept of “binding” is defined as a legal obligation not to raise tariffs on particular products above the rate specified in a country’s schedule of concessions. Binding tariffs provide greater commercial certainty by creating a ceiling on tariffs that can be applied by a country.

¹⁰The first two phases often overlap at times, as parties request more information from the applicant before proceeding with the negotiations.

Figure 1: WTO Accession Process



Legend

WP = Working Party

Source: GAO analysis, based on WTO document, "Accession to the World Trade Organization: Procedures for Negotiations under Article XII."

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- Fact-finding: As figure 1 illustrates, in the first phase of fact-finding the WTO working party,¹¹ assisted by the Secretariat,¹² collects and synthesizes information on the applicant's trade regime. The applicant submits a detailed outline of its trade policies and practices and answers questions until the working party has sufficient information to begin negotiations.
 - Negotiation: Figure 1 shows that the second phase of the process follows a two-track approach, involving both bilateral and multilateral negotiations. On a bilateral basis, each working party member negotiates with the applicant on its specific commitments on goods and services under the WTO agreements. The applicant submits an overall market access offer as the starting point for the negotiations, detailing how the country will lower barriers to trade. Although these negotiations are conducted bilaterally, any agreement reached between two countries will apply to all WTO members, as the principle of MFN requires. In the multilateral negotiations, the working party and the applicant negotiate terms for how the applicant will adhere to WTO's principles and technical guidelines, so that the applicant will meet the normal obligations and responsibilities of membership. For example, a country might be asked where and when it would publish new laws, in order to comply with a WTO transparency requirement.

The negotiation phase results in four documents, which detail the results of the negotiations and make up the applicant's final accession package:

(1) The Consolidated Schedules: These detail the applicant's specific market access commitments under various WTO agreements, primarily covering individual tariff lines for goods and services. They are annexed to the protocol as an integral part of the agreement.

¹¹The working party is created to oversee the negotiations and is open to all interested members of the WTO.

¹²The WTO Secretariat provides administrative and technical support. For example, the Secretariat ensures that parties meet documentation requirements.

(2) The Protocol: This is usually a brief document¹³ containing the terms of accession and affirming the applicant's adherence to WTO guidelines and principles.

(3) The Working Party Report: This provides a narrative on the results of the negotiations. Frequently, the report includes specific commitments made by the applicant regarding how it will meet WTO requirements. Commitments detailed in either the report or the protocol carry the same legal weight for the applicant, according to WTO and USTR officials.

(4) The Draft Decision: Written by the working party, this document affirms the working party's consensus decision on the applicant's bid for accession.

After the working party members conclude all the negotiations and reach consensus on language detailing the terms and conditions for the applicant's membership, they will forward the package to the General Council.

- WTO Decision: The third phase in figure 1 is the formal decision process, in which the General Council (comprised of all WTO members)¹⁴ approves (or rejects) the terms and conditions of the applicant's package. Traditionally, the General Council reaches decisions by consensus. However, if consensus cannot be reached, the draft decision can be approved by a two-thirds majority. Any country that decides to forgo normal WTO obligations and benefits ("non-application"), including MFN, must notify the Council before the Council approves the accession package.
- Implementation: Finally, the last phase in figure 1 is implementation of the applicant's WTO commitments. The applicant's WTO obligations enter into force 30 days after the General Council's approval and the applicant subsequently files its acceptance of membership. The accession package is part of the applicant's WTO agreement, and the acceding country is equally bound by the provisions of the WTO agreements and the commitments in the accession package. In some cases, the applicant's parliament or other legislative body must pass legislation to allow for accession before the applicant submits its acceptance. Applicants must also make the necessary internal adjustments as required by the accession package before the 30-day period begins. The General Council approves the draft decision,

¹³China's draft protocol and supporting documents are much more lengthy and detailed than those of most WTO applicants.

¹⁴The General Council has the authority to carry out the responsibilities of the Ministerial Conference, which must approve membership, so in this sense they are one and the same (and are often used interchangeably).

and then the applicant becomes a member. The most recent countries to join—Ecuador, Mongolia, Bulgaria, and Panama—were required to eliminate or begin to phase out most trade practices incompatible with WTO rules immediately upon accession.

Legal Framework Affecting China's WTO Accession

At this point, my statement will discuss (1) USTR's requirement to consult with Congress before a U.S. vote on China's WTO membership, (2) presidential determinations on China's state trading enterprises, (3) provisions in U.S. law affecting China's MFN status, (4) the potential use of WTO's non-application provision if China joins the WTO, and (5) implications for the United States if non-application is invoked.

Consultation Requirement

Under U.S. law, USTR is required to report to and consult with appropriate congressional committees before any WTO General Council vote on an applicant's membership when a vote would either substantially affect U.S. rights or obligations under the WTO agreement or potentially entail a change in federal law.¹⁵ In view of China's importance to U.S. foreign trade and the MFN issue described in our later comments, it is clear that this consultation requirement would apply to a vote on China's membership in the WTO.

Presidential Determinations on State Trading Enterprises

Before China joins the WTO, another United States law¹⁶ requires the President to make certain determinations about China's state trading enterprises.¹⁷ Specifically, the President must decide (1) whether China's state trading enterprises account for a significant share either of China's exports, or China's goods that are subject to competition from goods imported into China; and (2) whether these enterprises adversely affect U.S. foreign trade or the U.S. economy. If both determinations are affirmative, the WTO agreement cannot apply between the United States and China until either China enters into an agreement that addresses the

¹⁵The Uruguay Round Agreements Act (P.L. 103-465, 108 Stat. 4828, codified at 19 U.S.C. 3531-32). The term "appropriate congressional committees" means the House Committee on Ways and Means, the Senate Committee on Finance, and any other congressional committees that have jurisdiction over the matter with respect to which consultations are to be held.

¹⁶The Omnibus Trade and Competitiveness Act of 1988 (P.L. 100-418, 102 Stat. 1133, codified at 19 U.S.C. 2905).

¹⁷For purposes of this provision, state trading enterprises are defined as government entities or businesses that are owned, controlled, or supported by the government and that purchase goods or services in international trade for purposes other than government use.

operations of state trading enterprises, or legislation is enacted approving application of the WTO agreements to China.

China and U.S. MFN Law

A key legislative action Congress will face before China becomes a WTO member is whether to remove China from coverage under title IV of the Trade Act of 1974. Specifically, section 401 generally requires the President to deny MFN to products from a number of countries, including China.¹⁸ Section 402, better known as the “Jackson-Vanik Amendment,”¹⁹ permits a 1-year exception when the President determines that a country, such as China, substantially complies with certain freedom of emigration objectives.²⁰ The President can recommend renewal of these waivers for successive 12-month periods if he determines that further extensions will substantially promote these objectives. These recommendations must be made 30 days before the end of the previous year’s waiver period, that is, by June 3. Congress has up to 60 days from the end of the waiver period to pass a joint resolution disapproving the waiver. If necessary, Congress has an additional 15 days to override any presidential veto of such a resolution. China first received a waiver in 1980, and U.S. presidents have renewed the waiver from 1981 to most recently, on June 3, 1998.

Since the Jackson-Vanik amendment provision only allows a 1-year waiver of title IV restrictions and Congress can disapprove the waiver, the administration plans to ask Congress to enact legislation that would remove China from title IV’s coverage. The administration believes that temporary, that is, conditional MFN under Jackson-Vanik conflicts with the WTO obligation to provide unconditional MFN to WTO members.

In the past, Congress has passed legislation removing certain WTO/GATT members from title IV’s coverage and granting them permanent MFN. For example, in 1996, Congress enacted legislation²¹ providing the President with discretionary authority to grant permanent MFN to Bulgaria, which the

¹⁸Like China, Albania, Armenia, Belarus, Georgia, Kazakhstan, Kyrgyzstan, Laos, Moldova, Russia, Ukraine, Uzbekistan, and Vietnam, which also wish to join the WTO, receive conditional MFN from the United States. Estonia, Latvia, Lithuania, and Cambodia have also applied for WTO membership and have been provided permanent MFN under U.S. law.

¹⁹Section 409 of title IV, which deals with certain other sanctions against countries with emigration restrictions, is also part of the Jackson-Vanik amendment.

²⁰The country cannot deny its citizens the right or opportunity to emigrate; impose more than a nominal tax on emigration or on documents required for emigration; or impose more than a nominal tax, fee, or any other charge on any citizen because of his or her desire to emigrate to any country.

²¹Public Law 104-162, sec. 2.

President did on September 27, 1996.²² This approach appears to increase the administration’s leverage to obtain final commitments. At least one bill, S. 737, currently pending in Congress takes the same approach for China. Other pending bills, S. 1303 and H. R. 1712, for example, do not provide the President this kind of discretionary authority. Instead, they provide that on the day China becomes a WTO member title IV shall no longer apply, and China’s products shall receive MFN.

Non-application Clause

If China becomes a WTO member and Congress has not passed legislation removing China from title IV’s coverage, the administration plans to invoke the “non-application clause” of article XIII of the WTO agreement. The “non-application clause” permits either a WTO member or an incoming member to refuse to apply WTO commitments to each other. In the past, the United States has invoked non-application when countries have joined the WTO (or GATT) and Congress had not repealed title IV of the Trade Act for the incoming member. Table 1 lists these instances.

Table 1: Countries Lacking Unconditional MFN Status Upon Joining WTO/GATT

Country	Accession date to WTO/GATT	Date unconditional MFN granted by United States
Romania	Nov. 14, 1971	Nov. 7, 1996
Hungary	Sept. 9, 1973	Apr. 10, 1992
Mongolia	Jan. 29, 1997	Pending ^a

Legend

NA = Not applicable

^aThere is pending legislation before Congress that would grant Mongolia this status.

I would like to point out four important characteristics of the WTO non-application clause. A member (and, when appropriate, an incoming member):

- (1) must notify the WTO of its intent to invoke non-application before the new member’s terms of accession are approved by the General Council;
- (2) may invoke non-application and still vote to have the new member admitted to the WTO; the United States did this for Mongolia’s accession in 1997;

²²Proclamation 6922, 61 Fed. Reg. 51205 (Sept. 27, 1996).

(3) cannot invoke non-application selectively, because the clause covers all WTO obligations. For example, the United States cannot choose to withhold its WTO MFN obligation and then apply other WTO provisions to China such as dispute settlement procedures; and

(4) may later rescind non-application, resulting in both parties applying all WTO rights and obligations to each other. For example, the United States did this for Romania and Hungary.

Implications of Non-application for the United States

If China joins the WTO and the United States invokes non-application, any MFN rights between the United States and China will come from the 1979 U.S.-China Bilateral Agreement on Trade Relations. Although neither we nor USTR have compared in detail the scope of MFN under the 1979 agreement and that provided in the WTO agreements, the coverage under the former does not appear to be as comprehensive. For example, the 1979 agreement does not establish clear MFN obligations for services and service suppliers,²³ nor does it provide for compulsory dispute settlement procedures. For instance, if the United States believes that China has violated its WTO commitments, the United States would be unable to bring China to WTO's dispute settlement body.

An important consequence of the United States invoking WTO non-application is that if China becomes a member, it does not have to grant the United States all the trade commitments it makes to other WTO members, both in the negotiated accession package or in the underlying WTO agreements. Because U.S. businesses compete with business from other WTO members for China's markets, this could potentially put U.S. business interests at a considerable competitive disadvantage. For example, the United States may not benefit from Chinese concessions regarding services, such as the right to establish distribution channels in China. While the United States would continue to benefit from Chinese commitments made in bilateral agreements concluded with the United States, the commitments are not as extensive as those in the WTO agreements.²⁴

²³When the United States invoked non-application for Romania and Hungary, trade relations with those countries were established through bilateral agreements, which were fairly extensive in comparison to GATT/WTO commitments, according to an International Trade Commission official.

²⁴Nevertheless, the United States might still benefit indirectly from China's WTO commitments for increased transparency and certain changes in standards and regulations.

In summary, the size of the Chinese economy and the extent of its reform efforts create challenges for negotiators and policymakers trying to integrate China into the WTO. As part of any congressional deliberation to remove China from coverage of title IV of the Trade Act, it will be important to evaluate China's accession package, and the advantages and disadvantages of providing China permanent MFN. This would include determining if the accession package has met the administration's objective of producing a "commercially meaningful" agreement. Congress will be evaluating an agreement that covers a wider array of issues than those of other new WTO members with MFN restrictions. As requested, we will be working with your staff to help evaluate this agreement when it is finalized.

This concludes my statement for the record. Thank you for permitting me to provide you with this information.

U.S.-China Bilateral Trade Agreements

The framework for current U.S. trade relations with China is based upon the Agreement on Trade Relations¹ that was signed on July 7, 1979. The agreement established reciprocal Most-Favored-Nation (MFN) status between the two countries and committed both parties to protect intellectual property. Since then, the United States has attempted to increase market access and reduce trade barriers and other trade distorting policies and practices by entering into numerous bilateral trade agreements with China (see table I.1). Nevertheless, China's implementation of these agreements has been uneven, according to the U.S. Trade Representative (USTR). China still restricts imports, subsidizes Chinese exports, and maintains significant barriers to foreign business penetration, according to USTR.

For example, the United States has entered into a series of agreements with China regarding China's protection of intellectual property rights (IPR). Under the Memorandum of Understanding on the Protection of Intellectual Property Rights signed in 1992, China amended its patent law, issued copyright regulations, joined international copyright conventions, and enacted protection for trade secrets. However, U.S. officials subsequently determined that China did not establish an adequate and effective mechanism for IPR enforcement. As a result of a Special 301² investigation, the two parties signed an additional IPR agreement in 1995 in which China committed to (1) provide improved protection for copyrights, (2) strengthen border controls, (3) institute trademark law modernization, and (4) intensify a "Special Enforcement Period" aimed at cracking down on piracy. However, China's continued insufficient implementation of the 1995 IPR agreement led the United States to threaten to impose sanctions in May 1996; the two parties avoided sanctions with the signing of an agreement in June 1996, which confirmed China's most recent attempts to enforce the 1995 agreement.

In addition, the United States and China have signed a series of bilateral trade agreements to improve the regulation and pricing of satellite launch services. In 1995, the United States and China renewed the Bilateral Agreement on International Trade in Commercial Space Launch Services for the period between 1995 and 2001. To further clarify the agreement's

¹The information contained in this appendix is drawn from USTR and International Trade Commission documents.

²Under "Special 301" of the 1974 Trade Act, as amended, USTR performs an annual review to identify countries that do not provide adequate or effective protection for U.S. intellectual property rights. If a country is designated a "priority foreign country," USTR must decide within 30 days whether to initiate a Special 301 investigation into the country's IPR practices. 19 U.S.C. 2242, 2412.

Appendix I
U.S.-China Bilateral Trade Agreements

provisions on low earth orbit satellites (LEO), the two countries signed an annex containing specific LEO pricing guidelines in 1997.

Table I.1: U.S.-China Bilateral Trade Agreements, 1984-1997

Agreement	Date signed	Issue
Accord on Industrial and Technological Cooperation	1/12/84	Committed the United States and China to promote and facilitate technology transfer and trade in technology products
Memorandum of Understanding on the Protection of Intellectual Property Rights	1/17/92	Committed China to provide significantly improved protection for U.S. inventions and copyrighted works
Memorandum of Understanding on Prohibiting Import and Export in Prison Labor Products	6/18/92	Permitted U.S. embassy officials to visit Chinese prisons suspected of producing goods for export to the United States
Memorandum of Understanding Concerning Market Access	10/10/92	Committed China to changes in its import regime, including gradual elimination of most nontariff barriers such as quotas and licenses, elimination of import substitution policies, publication of all trade laws and regulations and ban on the use of sanitary and phytosanitary standards as trade barriers
Memorandum of Agreement to Renew the Bilateral Agreement on International Trade in Commercial Space Launch Services	3/13/95	Specified limits on China's geosynchronous earth orbit (GEO) launches and improved GEO pricing practices
Agreement on Providing Intellectual Property Rights Protection	2/26/95	Committed China to take specific actions to provide protection of IPR for U.S. companies and provide market access for U.S. intellectual property-based products
Agreement on Intellectual Property Rights	6/17/96	Outlined the steps China took to implement the 1995 IPR agreement and provided more detailed market access guidelines concerning IPR
Agreement on Trade in Textiles and Textile Products	2/1/97 ^a	Opened the Chinese market to textile and apparel exports from the United States by reducing tariffs and binding tariffs at applied rates
Interim Agreement on Market Access for Foreign Financial Information Companies	10/24/97	Secured market access terms for foreign financial information companies operating in China
Agreement to Strengthen Space Launch Trade Terms	10/27/97	Placed guidelines on the Chinese pricing of LEO launches

^aFinal exchange of diplomatic notes has not yet occurred. The agreement is being applied provisionally in the interim.

Sources: USTR 1998 Trade Policy Agenda and 1997 Annual Report; United States International Trade Commission (USITC) The Year in Trade (1992, 1995, 1996); Statement of Ambassador Michael H. Moskow, Deputy USTR, on the Preservation of MFN Status for China, Before the Subcommittee on Trade, House Ways and Means Committee (June 29, 1992); 1998 National Trade Estimate Report on Foreign Trade Barriers.

Overview of China's Economy

China is undergoing a historic transformation, as market reforms and integration with the world economy create growth and increased trade and investment. In 1997, China's second largest export market after Hong Kong was the United States; China's bilateral trade surplus with the United States has more than doubled since 1993 to about \$50 billion in 1997. However, substantial trade and investment impediments remain. According to U.S. government and foreign officials, the size of the Chinese economy and the extent of its reform efforts create challenges to negotiators and policymakers trying to integrate China into the World Trade Organization (WTO). At the end of this appendix, we provide a table with some statistics on the Chinese economy.

China's Economy

According to our review of the economic literature, China, for almost 30 years prior to 1979, had a rural, developing economy with relatively few connections to the rest of the world. The Chinese Communists ruled over a centrally planned economy in which prices were set by the state. In late 1978, China's leaders introduced market reforms into the agricultural sector, where 71 percent of China's labor force worked. As agriculture yield increased, market reforms were introduced into other specific sectors and locales and then gradually expanded to other regions and sectors of the economy. Today, almost all sectors of the economy are a mix of market-oriented reforms and state planning. Experts generally credit these reforms and China's high rates of investment and saving as principal reasons for China's high growth rates during the last 20 years. They also credit these reforms for making China's economy much more developed, open to international trade and investment, and market-oriented.

China's economy appears to be very large and growing quite quickly, although not as fast as indicated by the widely publicized Chinese official figures. According to official Chinese figures, in 1997 the gross domestic product (GDP) was \$900 billion, per capita GDP was \$724, and growth since 1986 averaged almost 10 percent per year.¹ The most recent data from the Organization for Economic Cooperation and Development (OECD) suggest that China is the second-largest economy worldwide.

In 1997, China was the world's 10th largest exporter, 12th largest importer, and the largest trading nation that is not a WTO member. According to the economic literature, China has become increasingly open to international

¹All dollar data are current/nominal dollars.

trade and investment since 1978, although it retains significant trade and investment barriers.

Substantial Chinese Trade and Investment Impediments Remain

China has been negotiating to join the WTO and its predecessor, the General Agreement on Tariffs and Trade (GATT), since 1986. Despite substantial reforms, China will have to make significant changes to its economy to meet WTO rules and obligations.

Today, China still restricts imports, promotes and supports Chinese exports, and maintains significant barriers to foreign business penetration, according to USTR and Commerce Department reports. They report that China's import restrictions include high tariffs for specific sectors and other taxes on imports; nontariff barriers such as import licenses, import quotas, limitations on which enterprises can import, and limitations on access to foreign exchange. They also report that China promotes exports by providing exporters with access to funds, freight services, and inputs on noncommercial terms. China also provides exporters with income tax reductions and imposes foreign exchange earning and export requirements on foreign corporations in China.

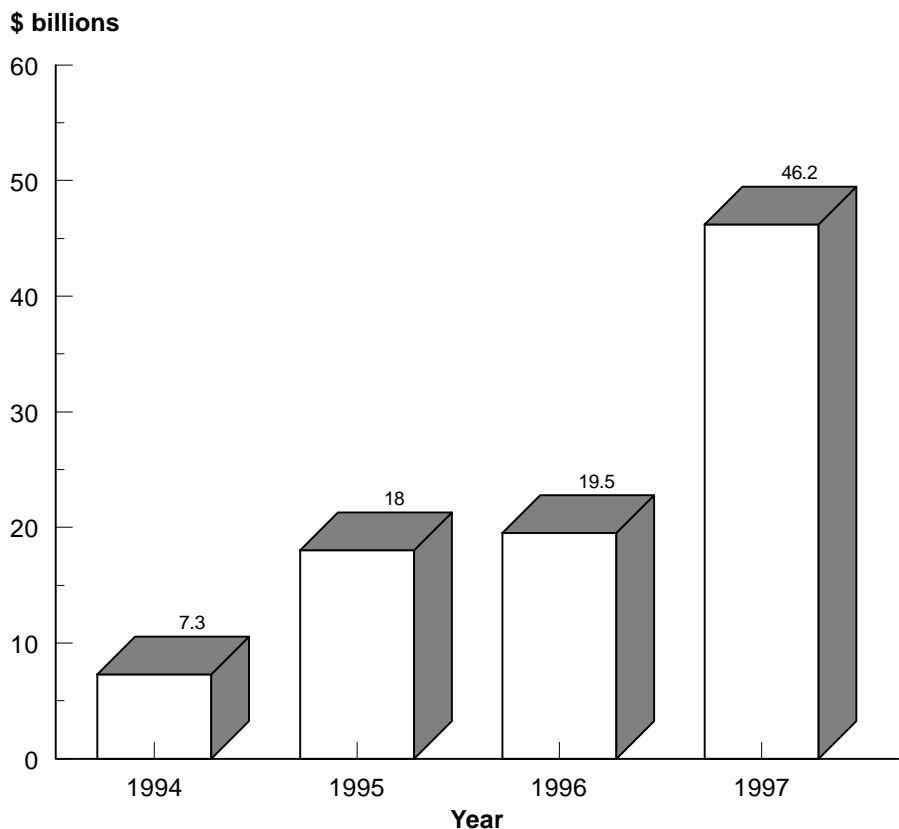
According to these reports, significant barriers or impediments to foreign business operating in China include guiding foreign investment to certain sectors; protecting state-owned enterprises from competition by law, regulation, and/or custom; restricting the opening of branches of foreign banks, insurance companies, accounting, and law firms to selected companies and particular locales; and prohibiting representative offices of foreign firms from signing sales contracts or billing customers. They also report on problems from excessive bureaucracy and corruption in China, especially regarding government procurement practices. The corruption problem is confirmed by private studies; one ranked China as the fifth most corrupt among 54 countries surveyed in 1996.

Balance of Payments Accounts

From 1980 until 1994, China's trade and current account balance (its goods, services, income, and current transfers) were more often in deficit than surplus. Current account deficits generally were financed by capital inflows, particularly foreign direct investment, which grew relatively slowly until 1992, and by borrowing from the World Bank. The Chinese government's holding of foreign exchange, the main component of its international reserves, fluctuated moderately.

Beginning in 1993, China has had large capital inflows, due to substantial and growing levels of foreign direct investment. China's goods surplus grew to \$7.3 billion in 1994 from a \$10.7 billion deficit in 1993. It then grew to \$18 billion in 1995, and then jumped to \$46.2 billion in 1997. Goods exports rose steadily from \$102.6 billion in 1994 to \$182.7 billion in 1997. China's goods imports increased more slowly from \$95.3 billion in 1994 to \$136.5 billion in 1997. China's goods and services balance grew steadily from \$7.6 billion in 1994 to \$17.6 billion in 1996, then rose to \$40.5 billion in 1997 (see fig. II.1).

Figure II.1: China's Surplus in Goods Trade With the World



Source: International Monetary Fund, International Financial Statistics; China's State Statistical Bureau; U.S. Commerce Dept.

At the beginning of 1994, China devalued its official exchange rate to that on the private market, and then rapidly gained foreign exchange under a managed float system at the rate of \$22 billion to \$35 billion per year. At the end of 1997, China's foreign currency reserves were second only to Japan's, at \$139.9 billion.

China's Bilateral Trade With the United States

China's surplus in goods trade with the United States has continued to increase for more than a decade. The bilateral surplus rose from \$2.8 billion in 1987, to \$29.5 billion in 1994 (the year China last devalued its currency), to \$49.8 billion in 1997, according to U.S. Commerce Department figures. U.S. goods imports from China have rapidly grown from \$6.3 billion in 1987, to \$38.8 billion in 1994, to \$62.6 billion in 1997. U.S. goods exports to China grew more slowly from \$3.5 billion in 1987, to \$9.3 billion in 1994, to \$12.8 billion in 1997. By 1997, the U.S. goods deficit with China was second to that of Japan for the third straight year. In 1997, goods imports from China were 7.2 percent of all U.S. goods imports, with leading imports of electrical machinery and equipment; toys, games, and sports equipment; footwear; boilers and machinery; and clothing accessories and apparel, much of which tend to be labor intensive. In 1997, U.S. goods exports to China were 1.9 percent of all U.S. goods exports, with leading U.S. exports to China consisting of Customs categories of nuclear reactors, boilers, and machinery; aircraft and spacecraft; electrical machinery and equipment; and fertilizers. In 1997, the United States was China's second-largest goods export market after Hong Kong, and third-largest source of goods imports after Japan and Taiwan. (See table II.1.)

Appendix II
Overview of China's Economy

Table II.1: Economic Data of China: 1987-97

Billions of current U.S. dollars, unless otherwise noted

	1987	1988	1989	1990	1991	1992	1993	1994	1995	1996	1997
Goods trade balance	\$(1.7)	\$(5.3)	\$(5.6)	\$9.2	\$8.7	\$5.2	\$(10.7)	\$7.3	\$18.0	\$19.5	\$46.2
Exports	34.7	41.1	43.2	51.5	58.9	69.6	75.7	102.6	128.1	151.1	182.7
Imports	(36.4)	(46.4)	(48.8)	(42.4)	(50.2)	(64.4)	(86.3)	(95.3)	(110.1)	(131.5)	(136.5)
Goods and services balance	0.3	(4.1)	(4.9)	10.7	11.6	5.0	(11.5)	7.6	12.0	17.6	40.5
Exports	39.2	45.9	47.8	57.4	65.9	78.8	86.9	119.2	147.2	171.7	207.2
Imports	(38.9)	(50.0)	(52.8)	(46.7)	(54.3)	(73.8)	(98.3)	(111.6)	(135.3)	(154.1)	(166.8)
Current account balance	0.3	(3.8)	(4.3)	12.0	13.3	6.4	(11.6)	6.9	1.6	7.2	30.0
Financial account balance	6.0	7.1	3.7	3.3	8.0	(0.2)	23.5	32.6	38.7	40.0	23.0
Inward foreign direct invest	2.3	3.2	3.4	3.5	4.4	11.2	27.5	33.8	35.8	40.2	44.2
Overall balance of payments	4.8	2.4	(0.5)	12.0	14.5	(2.1)	1.8	30.5	22.5	31.7	35.7
Foreign exchange (yr. end)	15.2	17.5	17.0	28.6	42.7	19.4	21.2	51.6	73.6	105.0	139.9
Yuan/U.S. dollar (yr. end)	3.722	3.722	3.972	4.847	5.347	5.545	5.767	8.584	8.341	8.314	8.288
Yuan/U.S. dollar (avg.)	3.722	3.722	3.765	4.783	5.323	5.515	5.762	8.619	8.351	8.314	8.290
China's trade balance with the United States	\$2.8	\$3.5	\$6.2	\$10.4	\$12.7	\$18.2	\$22.8	\$29.5	\$33.9	\$39.5	\$49.8
Exports	6.3	8.5	12.0	15.2	19.0	25.7	31.5	38.8	45.6	51.5	62.6
Imports (F.A.S.)	(3.5)	(5.0)	(5.8)	(4.8)	(6.3)	(7.5)	(8.8)	(9.3)	(11.7)	(12.0)	(12.8)
GDP official	321	401	449	388	406	483	601	543	698	825	902

Legend

F.A.S. = free-alongside-ship (a method of export and import valuation whereby the seller's price includes charges for delivery of goods up to the port of departure).

Note: Items in parenthesis indicate a deficit.

Source: International Monetary Fund; International Financial Statistics; China's State Statistical Bureau; U.S. Commerce Dept.

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